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DISCUSSION PAPER NO. 28
GOVERNMENT SUPPORT FOR
START-UP VENTURES
FACTORS TO BE CONSIDERED
by
John Hutchinson
and Paul Ward
June 1984

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1. Introduction

This is a companion paper to "Government Support for Troubled Companies". It deals with the factors to be considered in providing financial assistance to start-up ventures, rather than to existing companies which are in financial trouble. The purpose of this paper is to outline some of the major business criteria and factors the government should consider in assessing the merits of a request for assistance from a start-up company. It describes the considerations that an auditor would expect a government department to take into account in granting assistance to a new venture.

Many of the factors which should be considered are similar to those outlined in the "Government Support for Troubled Companies" paper. However, the emphasis on specific factors varies. For example, in the case of a start-up company, historical financial information would not be available. Similarly, there would be no need to consider factors relating to the cause of current problems or how immediate short-term obligations would be met. On the other hand, factors relating to the validity of market projections and cost of production estimates are even more critical in the start-up phase of a company.

It is assumed here that the government's prime rationale in granting start-up assistance to a company is to achieve socio-economic and/or political benefits which it considers worthwhile for Canada. These socio-economic benefits will only be realized if the company becomes profitable, thereby ensuring continued operations. The focus of this paper is the factors that will contribute

to establishing a profitable company, not the socio-economic or political benefits themselves.

It is also assumed that the government would not grant assistance to a company unless it could satisfy itself that the company had exhausted all conventional sources of financing and that further funds were required if the new business venture was to have a realistic possibility of success. The onus of providing detailed, pertinent information for evaluation of the application would be on the applying company. The government's role would be to request and review the information.

This paper identifies the criteria which the government should consider prior to granting assistance, the information expected from an applicant, and the factors to be considered in reviewing this information. Further considerations are whether the government has set any conditions on the assistance, how these will be monitored, and how assistance will be terminated or repaid. Key factors in establishing whether or not a particular applicant meets the criteria are then referred to.

2. Criteria for Government Support

- The additional financing must be necessary to make the new business entity viable.
- All other sources of financing, public and private, must have been exhausted.

- Government intervention must be determined to be the only feasible solution to obtain the desired socio-economic benefits.
- Assistance should not conflict with trade agreements.
- The assistance package should be designed with conditions such that it has a reasonable probability of resulting in the establishment of a viable company.
- The total ultimate cost of the assistance should be considered at the beginning, although aid should if possible be limited to a single occasion.
- The government should minimize the cost of achieving its goals. The costs of the proposed assistance package must be justified by the benefits to be derived from it.
- Projected cash flows must not indicate excessive returns to private equity holders.

3. Information and Documentation

- Company history (if any).
- Ownership, including statement of degree of Canadian ownership.

- Details of proposed corporate and financial structure and relationships with affiliated companies.
- Details, including names, of other equity participants.
- Brief outline of the company's proposed nature of operations, products and markets.
- Details of patents and/or licensing agreements protecting any new product or concept.
- Listing of the major customers and expected percentage of sales to each.
- Details of proposed relationships with major customers and major suppliers, including comments on any degree of dependency on any of these parties.
- Description of the major categories of personnel to be employed; that is, the type of skills required, and the sources.
- A detailed business plan for the next three years, covering the following:
 - operations;

- capital expenditures; and
- research and development.
- Information on attempts to find alternate funding.
- Details of any federal, provincial or municipal government assistance arranged or about to be received in the form of grants, contributions, loan guarantees or contracts, and explanations of why no further assistance of this type is available.
- Details of any special government assistance to be received in the form of income tax incentives, customs or duty credits, tariff regulations, etc.
- Proposals and timetables for repaying government assistance.

4. Business Plan

The company's business plan for the next three years should include:

- assessment of market and the company's potential market share, including market forecasts and assumptions;
- assessment of availability of manpower;

- assessment of proposed management structure and controls;
- costs of production;
- facilities;
- availability of raw materials;
- transportation of raw materials to plant;
- transportation of products to markets;
- research and development;
- marketing;
- manpower;
- analysis of projected financial position and pro-forma financial statements for next three years, including
 - projected earnings summary,
 - projected cash flow,

- proposed capital expenditures, and
- proposed use of government assistance.

The amount of detail and supporting documentation to be provided by a company will depend on its size and degree of sophistication.

5. Review of Business Plan

The most significant problem in assessing the prospects of a new company, or a company about to be formed, is its lack of history. Assessing the business plan of such a company means there must be more emphasis on collecting evidence from sources external to the company than when a company has operated for some time. While this is a practical problem, the auditor should also examine carefully whether the government has considered the following in assessing the plan.

- Particular attention should be paid to the company's information on its attempts to obtain financing from other sources.
- The other sources of financing should be contacted to confirm the tentative arrangements made with them, and their ability to raise the equity funds should be assessed.
- Marketing. External evidence should be obtained to support the marketing information supplied by the company, including not

only the total sales figure in the financial projections but the following:

- total market;
- market share likely to be captured by the company;
- location of markets - transportation costs;
- marketing strategy that is most likely to be successful;
- pricing;
- distribution networks to be used; and
- service network to be established.

- Management. External evidence should be obtained to attest to the ability and competence of the new company's management team, including:
 - background of owner-managers; and
 - background of managers.

- Production. External evidence should be obtained as to the feasibility and costs of the proposed production process:
 - labour costs and availability;
 - availability of plant and equipment;
 - use of proven technology; availability of technical support;
 - efficiency of the machinery, layout and production process;
 - availability of raw materials and supplies;
 - location of sources of supply and transportation costs; and
 - patent and licensing costs, rights and limitations.
- The business plan should allow assessment of the impact of alternatives.
- The implicit and explicit economic assumptions included in the plan should be reviewed.
- The plan should be adjusted, if necessary, to reflect the appropriate economic assumptions as well as the appropriate industry assumptions.

- If the costs of production projections appear to be inconsistent with industry results, these should be reviewed. This could include a review of the cost estimates (both capital and operating) by independent technical experts.
- The overall accounting and financial assumptions included in the business plan should be reviewed for consistency and to ascertain the basis for projections of such items as levels of inventory, accounts receivable and accounts payable. The assumptions should be compared to industry standards, if possible.
- The financing assumptions included in the business plan should be reviewed. Ideally the plan should be prepared so that the impact of various types and levels of government assistance, including the case of no assistance, can be evaluated.
- The business plan should specifically reflect assumptions made by the company with respect to the termination of government assistance. The cash flows should detail when funds are expected to be received and when they are to be repaid, if this is required.

6. Conditions of Assistance

The government may set conditions for assistance. These should be clearly stated and agreed to in writing before assistance is granted. Conditions could include:

- linking payments to progress against production plan milestones;
- provision for independent verification of company statements on production progress; or
- provision for repayment of assistance or for termination of assistance based on company performance.

7. Monitoring

The government should establish a procedure for monitoring for compliance any condition imposed as part of the assistance package. This would include reviewing on a regular basis:

- production accomplishments against targets;
- company profitability against requirements for repayment of assistance;
- any other condition attached to the assistance.

8. Termination of Assistance

- Projections of repayment of government assistance, if applicable, should be compared regularly to original projections in the request for assistance.

- If actual repayment or repayment projections differ from the original schedule, the reason should be addressed without delay by the government and the company.
- Because of the risk being taken by government, provision should be made for equity redemption (where applicable) in a shareholder agreement when earnings or debt/equity ratio reach a certain level.

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